

## ANOTHER LOOK AT SHARING ARRANGEMENTS— SOME DRAFTING SUGGESTIONS

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### I. ADVANTAGES SOUGHT IN SHARING ARRANGEMENTS

The economics of petroleum exploration, development, and operation have popularized arrangements for spreading risks and broadening the base of capital investment. The difficulty of finding reserves and the increasing costs of exploration and drilling affect managerial decision-making in both the small and large business units. The small business units are, of course, concerned about risking a substantial percentage of their total resources in one venture. Even the larger units, cautious of unnecessary risk taking, will seek devices for risk spreading and capital formation; for the fact that the highest rate on corporate incomes is less than that on individual incomes may result in proportionately larger cash outlays after taxes by a corporation in a given venture than might result in the case of an individual.<sup>1</sup> Therefore, in the case of both small and large units, whether they be corporate or non-corporate, the objectives of various arrangements which are negotiated in the industry are the same. They are to enable the initial finders or holders of interests in potentially valuable mineral properties to retain, or to assign and reacquire at a later date, some economic interest in the property and at the same time to accord to those who provide capital or services connected with exploration, drilling, and development the maximum economic and tax inducements to risk taking.

The general patterns are well known in the industry. The details will take almost as many forms as the ingenuity of client and counsel can devise. Typically, a drilling and development program may involve several groups. One, a promoter or operator group, holds or has access to the acquisition of properties to be

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<sup>1</sup> In scanning the annual reports of major companies, one may readily observe that most of the exploration, drilling, and operations are done on some sort of farm-out or joint-account basis. See McLean & Haig, *The Growth of Integrated Oil Companies* 402 (1954).

explored, drilled, and developed. Another group, an investor or capital providing group, provides capital to support expenditures necessary for exploration, drilling, and development. A third group may be desirous of contributing services, equipment, or supplies in exchange for an interest in the properties to be developed. The first group will want a depletable economic interest in the property in order to enjoy not only the income from production but the tax advantages of the depletion allowance. The second group will want to have a deduction for intangible drilling and development expenditures. Additionally, with respect to their investment in depreciable equipment to complete the well, they will want such ownership rights as give them the maximum depreciation deduction. Those contributing services, supplies or equipment will desire an arrangement pursuant to which their contribution will be a non-taxable transaction, and, they will desire an interest, the income from which will be subject to the depletion deduction.

In order to place the available business choices in the clearest focus, the presentation herein will deal with all forms or arrangements for pooling resources. Thus, the term "sharing arrangement" will refer to all kinds of contractual and organizational arrangements which effect the amassing of resources and the sharing of risks and benefits which result from exploration, drilling, development, and operation.<sup>2</sup>

The rash of articles and comments on sharing arrangements would seem to leave little more to be said.<sup>3</sup> And yet, upon a reading

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<sup>2</sup> Hambrick, "A New Look at the Carried Interest," Tenth Annual Tul. Tax Inst. 304, 333 (1961); 2 Williams & Meyers, *Oil and Gas Law* § 433, at 490 (1964).

<sup>3</sup> *E.g.*, Appleman, "Tax Considerations on Conducting an Oil Business as a Partnership, Corporation or Subchapter S Corporation," 8 Rocky Mt. Mineral Law Inst. 417 (1963); Bean, "Taxation of Carried Interests in Oil and Gas Transactions—In Retrospect and Prospect," 10 Kan. L. Rev. 391 (1962); Branscomb, "Allocating Income in Carried Interest Arrangements," P-H Oil & Gas Taxes § 2023 (1961); Breeding, "The Trend in Carried Interest Cases," 17 Sw. L.J. 242 (1963); Bullion, "A New Look at Tax Aspects of Oil and Gas Sharing Arrangements," Southwestern Legal Foundation, Eighth Annual Inst. on Oil and Gas Law and Taxation 603 (1957); Collie & Driscoll, "Partnership Oil and Gas Operations Under Provisions of the Internal Revenue Code of 1954," 33 Texas L. Rev. 792 (1955); Early, "The Investors Group: Setting Up an Oil and Gas Venture from the Tax Standpoint," Southwestern Legal Foundation, Fifth Annual Inst. on Oil and Gas Law and Taxation 451 (1954); Fillman, "Effect on the Investor's Group of New Subchapter K, 'Partners and Partnerships,' and the New Texas Limited Partnership Act," Southwestern Legal Foundation, Seventh Annual Inst. on Oil and Gas Law and Taxation 721 (1956); Hambrick, "A New Look at the Carried Interest," Tenth Annual Tul. Tax Inst. 304 (1961); Henry, "Farmout Agreements—Tax Consideration," 8 Rocky Mt. Mineral Law Inst. 163 (1963); McDowell, "Depletable Interests: Economic Interest vs. Economic Advantage," N.Y.U. 18th Inst. on Fed. Tax 517 (1960); Sneed, "Another Look at the Economic Interest Concept," Southwestern Legal Foundation,

of the recent cases of *United States v. Frazell*,<sup>4</sup> *James A. Lewis Engineering, Inc. v. Commissioner*,<sup>5</sup> and *United States v. Thomas*,<sup>6</sup> one readily perceives that the concept of sharing arrangements is still murky and requires continued elaboration and clarification. As will be shown, however, the results are not irreconcilable. The facts in these cases make demonstrably clear how much depends upon care and skill in drafting. With carefully documented transactions, the taxpayer ought to be able to predict and anticipate local and federal tax consequences. Often the difficulty results from the fact that the parties have not, in their documents, reached a clear meeting of the minds in planning for the taxation of their respective interests. One side may claim the benefits of a capital gain on a transaction which it contends to be a sale. Meanwhile, the other side may take the position that the transaction is some kind of compensatory or drilling arrangement which results in a deduction.<sup>7</sup> One side may calculate the depletion allowance on an amount of production without excluding therefrom that portion which the other side claims to be attributable to its own depletable economic interest.<sup>8</sup>

Accordingly, the purpose of this paper is to emphasize those considerations which the draftsman must take into account in establishing the relationship of the parties.

## II. LOCAL LAW PROBLEMS

### A. *The Property Interest*

Desirable tax results are usually the overriding considerations of a sharing arrangement. It is equally important, however, that the transaction be accomplished in accordance with local law,

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Tenth Annual Inst. on Oil and Gas Law and Taxation 353 (1959); Winstead, "Carried Interest and Net Profits Interest," Southwestern Legal Foundation, Second Annual Inst. on Oil and Gas Law and Taxation 517 (1951); 2 Williams & Meyers, Oil and Gas Law § 433, at 490 (1964); Comment, "Incorporation of the Carried Interest," 13 Oil & Gas Tax Q. 25 (1963); Comment, "Is the Carried Interest a Partnership?" 13 Oil & Gas Tax Q. 51 (1964); Comment, "Carried Interest Revisited by the Commissioner," 13 Oil & Gas Tax Q. 1 (1963); Note, 13 Oil & Gas Tax Q. 211 (1964); Comment, "Receipt of Economic Interest for Personal Services in Secondary Recovery Program," 12 Oil & Gas Tax Q. 190 (1963).

<sup>4</sup> 335 F.2d 487, rehearing denied, 339 F.2d 885 (5th Cir. 1964), cert. denied, 380 U.S. 961 (1965).

<sup>5</sup> 339 F.2d 706 (5th Cir. 1964).

<sup>6</sup> 329 F.2d 119 (9th Cir. 1964).

<sup>7</sup> E.g., *Platt v. Commissioner*, 207 F.2d 697 (7th Cir. 1953).

<sup>8</sup> A good example of inconsistent positions being taken by the Commissioner on both sides occurs in *Commissioner v. Southwest Exploration Co.*, and *United States v. Huntington Beach Co.*, 350 U.S. 308 (1956), in which the former was reversed and the latter affirmed.

especially if the interests of the parties may shift from one to another, or if they may be divested for a time and revested again in the future. For example, an individual may have a leasehold interest which he assigns in consideration of drilling and development, the assignee to own the property and collect the net revenues until he has been reimbursed for his costs. At this time a portion of the interest reverts to the assignor. In the alternative, the assignor may have an option, exercisable at an indeterminate future time, *e.g.*, at the end of the payout period, under which he may acquire part of the working interest, a net profit interest, an overriding royalty, or some combination of these interests. Another possibility is that the individual contributing the services for development receives a contract with the right to have the property interest conveyed to him sometime in the future.

A host of problems may arise with respect to the nature of such property interests. The fixing and priority of liens; the application of statutes of descent and distribution; the application of adverse possession; the formalities required on the part of guardians, administrators, trustees, and married women; and the application of the Rule Against Perpetuities and restraints on alienation are all affected by the particular category in which the interest may be placed.<sup>9</sup> If the property belongs to the marital community, due account must be taken of the wife's rights. Should the wife die during the payout period, for example, the interests of her heirs, devisees, and legatees should be clearly stated. If some variety of reentry right, or reacquisition option is exercisable following the death of either husband or wife, the documents should state the manner of exercise.

If an interest in property is encumbered, it is important, upon transfer, that the transferee execute and accept the assignment and that he acknowledge his assumption of any burdens or commitments. In the event of further assignments of the lease, the subassignees should undertake to carry out the obligations of the prior assignee, if this is the intention of the parties.<sup>10</sup>

Because the basic interest being dealt with is usually an oil and gas lease, or an interest therein, the delay rental clause in the usual "unless" lease will operate as a conditional limitation on the estate granted. Thus, in a sharing arrangement, if the interest in

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<sup>9</sup> See *Continental Supply Co. v. Marshall*, 152 F.2d 300 (10th Cir. 1945), *cert. denied*, 327 U.S. 803 (1946). See generally 1 Williams & Meyers, *Oil and Gas Law* §§ 201-32 (1964). For a discussion of property problems in connection with shooting options and selection leases, see Walker, "Pitfalls in Shooting-Options and Selection-Leases," 1 *Rocky Mt. Mineral Law Inst.* 239 (1955).

<sup>10</sup> See generally 2 Williams & Meyers, *Oil and Gas Law* §§ 401-23 (1964).

the lease is fractionated, it is of utmost importance that the responsibility with respect to payment of delay rental until drilling is commenced be clearly understood. Similarly, requirements of compliance with drilling and development obligations must be set out in the assignments and subassignments. Whether or not such obligations touch and concern the land so as to be covenants running with the land should not be left to chance;<sup>11</sup> careful drafting should make the obligations clear.

### *B. Contract and Tort Liability*

During the initial period the investor group may commit substantial sums for exploration, drilling, and development. They will seek to limit their liability insofar as possible in order to avoid exposure to suits stemming from personal injuries, property damage, and disputes over contractual provisions. Those contributing services, supplies, and equipment are likewise concerned that the acquisition of an interest does not expose them to losses greater than their commitments. Such exposure may be avoided in the initial period by: (1) using independent contractors in the performance of high risk functions such as geological and geophysical testing, drilling, and equipping the well;<sup>12</sup> (2) using one of the appropriate forms of business organization such as a limited partnership or a corporation; or (3) using nonrisk-bearing oil property interests such as the overriding royalty, net profit interest, production payment, or options to acquire interests in the future.<sup>13</sup> Although the use of nonrisk-bearing interests may be feasible for those providing services, supplies, or equipment, they may be of no particular avail for those supplying capital for intangible drilling and development costs. This is true because the investor group, in order to be entitled to a tax deduction for the costs which it underwrites, is required either to hold the operating or working interest or to agree to undertake the drilling in exchange for such interest.<sup>14</sup>

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<sup>11</sup> 5 Williams & Meyers, *Oil and Gas Law* § 883, at 554 (1964).

<sup>12</sup> See Keeton & Jones, "Tort Liability and the Oil and Gas Industry," 35 *Texas L. Rev.* 1 (1956); Masterson, "The Legal Position of the Drilling Contractor," *Southwestern Legal Foundation, First Annual Inst. on Oil and Gas Law and Taxation* 183, 196 (1949).

<sup>13</sup> For an excellent article on the relationship of the operating interest to the royalty and other interests, see Jones, "Exercise of Executive Rights in Connection with Non-Participating Royalty and Non-Executive Mineral Interests," *Southwestern Legal Foundation, Fifteenth Annual Inst. on Oil and Gas Law and Taxation* 35 (1964).

<sup>14</sup> In drafting of the regulations concerning intangible drilling and development costs, the Service is understood to have seriously considered allowing a deduction to those covering such costs regardless of the particular kind of interest held or acquired. This would, of course, have facilitated the drafting of sharing arrange-

After the initial period of exploration, drilling, and development, the parties may continue their relationship under one of the usual forms of operating agreements. In such case it is customary to agree that the arrangements shall not constitute a partnership and that the nonoperators shall be liable for ordinary costs and expenses, including the cost of insurance covering property damage, personal liability, workmen's compensation, and other risks. However, the insurance of some risks may be inadequate, and liability may arise with regard to an uninsured risk. Although the parties may agree with one another so as to limit the liability of some during operations, their action may be ineffectual as to third parties who have dealt with the group or its representative.<sup>15</sup> For example, a mining partnership might be held to exist as a matter of law. This would make each mining partner liable for the acts of the others under the mutual agency doctrine. It is thus important that the arrangement, both in its formal terms and in its implementation and execution, should negate the factors of joint ownership, joint operation, joint sharing of profits and losses, and common or community interest in the properties. Most importantly, any action or conduct which may actually or apparently give rise to a mutual agency relationship should be avoided.

As may be done during the drilling and development period, the parties may minimize risks in the operational period by contracting out the operating responsibilities to a separately organized operating entity. Finally, one holding an operating or working interest may avoid continuing exposure to liability by negotiating an exchange of such interest for an overriding royalty or net profit interest.

Under local law, the Uniform Partnership Act and Limited Partnership Act<sup>16</sup> along with their decisional gloss provide the greatest degree of predictability to legal consequences. The parties' relationships are well established by a substantial body of law. Nevertheless, the partnership may not be desired by the parties because they do not wish to keep partnership books, file partnership returns, conform to the same method of accounting, or use the same

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ments. Assume that the parties did not desire to use a limited partnership but did want the capital contributors to have the maximum intangible drilling and development costs deduction with minimum liability exposure. In such case, had the Treasury Regulations been more liberally drafted, an overriding royalty or net profit interest could have been assigned to the investor group from the outset.

<sup>15</sup> See, e.g., *Cross v. Pasley*, 270 F.2d 88 (8th Cir. 1959), *cert. denied*, 362 U.S. 902 (1960); *Mud Control Labs. v. Covey*, 2 Utah 2d 85, 269 P.2d 854 (1954).

<sup>16</sup> Tex. Rev. Civ. Stat. Ann. arts. 6132a, 6132b (1962); Ohio Rev. Code Ann. §§ 1775.01-.42, 1781.01-.27 (Page 1964).

depreciation methods. Therefore, the tax consequences of both partnership and nonpartnership forms will be considered.

### III. KINDS OF SHARING ARRANGEMENTS — TAX CONSIDERATIONS

In the remaining discussion, arrangements for spreading risks and accumulating capital are categorized in three groups.

A. *Contributor has no interest in the property being developed, but participates in a stipulated share of the cost of development in order to acquire geological and geophysical information.*

The motivation for using this type of arrangement might exist where a party, having an interest in mineral properties, desires to contribute to the drilling of a well on an adjacent tract in order to obtain geological and geophysical information, or, perhaps, to encourage a "play" in the area.

If the well is a producer, a bottom-hole contribution, *i.e.*, an agreement to contribute to the cost of drilling to a certain depth, irrespective of the success of the venture, is treated as an additional capital cost of geological and geophysical information attributable to the interest of the contributor. If the well is a dry hole and if it is assumed that the G and G (geological and geophysical) information obtained is worthless, the contribution may be deductible as a worthless asset. It is conceivable, of course, that a dry hole contribution, *i.e.*, an agreement to contribute to the cost of drilling to a certain depth, provided that the well results in a dry hole, could have value to the contributor and would have to be capitalized.<sup>17</sup> If property, rather than cash, is contributed, the contributor will capitalize the cost basis of the property contributed in G and G costs allocable to the particular tract which is benefited by such information; or, if the information acquired is worthless, then the contributor will deduct such cost.

On the recipient's side, either the cash received or the fair market value of the acreage contributed is credited to intangible costs. However, if some part of the contribution is stipulated to be a reimbursement for tangible costs, the recipient will credit such portion to tangible costs.

The essential drafting considerations in these arrangements are:

- (a) the wells to be drilled should be clearly identified as to legal description, time and manner of drilling, and depth to be drilled;<sup>18</sup>

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<sup>17</sup> I.T. 4006, 1950-1 Cum. Bull. 48.

<sup>18</sup> See, *e.g.*, *Anderson v. Bell*, 70 Wyo. 471, 251 P.2d 572 (1952); *Bute v. Holland*, 155 S.W.2d 69 (Tex. Civ. App. 1941); *Louisiana Progress Oil Co. v. McDaniel*, 154 S.W.2d 985 (Tex. Civ. App. 1941).

- (b) the time and manner of the contributor's payment should be stipulated;
- (c) the access to all G and G information should be clearly provided for;
- (d) in the case of a dry-hole letter, the definition of what constitutes a dry hole should be precisely set out.

A variation in the donation letters referred to above is the checkerboarding arrangement. A party owning the working interest may stake out well locations and assign every other location for development leaving the intermediate drill sites for his own development. Moreover, he will want access to all G and G information. The assignment in exchange for the drilling obligation will result in no tax consequences to assignor or assignee. The assignor's retained acreage will have the same basis as the entire acreage. The assignee may consider the drill sites as separate tracts or parcels of land since they touch only at the corners.<sup>19</sup> For pooling and unitization purposes and for maximum engineering efficiency, it is desirable to maintain control over as large an area as possible as this gives the greatest flexibility in selecting drill sites. Checkerboarding arrangements, therefore, may not be as attractive now as before.

Sometimes the parties will negotiate an arrangement whereby the assignor assigns only the acreage around the drill site plus some fraction, *e.g.*, one-half, of all other acreage. In such situations, however, the Service may contend that the value of the half of all other acreage assigned is in the nature of a bottom-hole contribution. This would offset the assignee-carrying party's deduction for intangible costs.<sup>20</sup>

*B. Contributor has an interest in the property to be developed; the arrangement is worked out so that he is carried for the development and later participates in the economic benefits.*

These arrangements include the relatively simple farm-outs, general and limited partnerships, and carried interests.

The contributor holding the working or operating interest will assign the interest to another who is obligated to drill and develop the property. The contributor retains a fraction of production as

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<sup>19</sup> Arthur Andersen & Co., Oil and Gas Federal Income Tax Manual 86-87 (1960). See also Brown, "Assignments of Interests in Oil and Gas Leases, Farm-Out Agreements, Bottom Hole Letters, Reservations of Overrides and Oil Payments," Southwestern Legal Foundation, Fifth Annual Inst. on Oil and Gas Law and Taxation 25 (1954).

<sup>20</sup> Bullion, "A New Look at Tax Aspects of Oil and Gas Sharing Arrangements," Southwestern Legal Foundation, Eighth Annual Inst. on Oil and Gas Law and Taxation 603 (1957).



an overriding royalty. The assignor, therefore, allocates whatever basis he had in the assigned property to the interest retained. Should the assignee pay any cash to the assignor for the assignment, the transaction is treated as a sublease. The bonus is depletable ordinary income in the hands of the assignor, and the capital cost of the sublease in the hands of the assignee is returnable through depletion.<sup>21</sup>

Adoption of the Uniform Limited Partnership Act in major producing states and in states having large capital markets, has allowed the limited partnership to become a popular device for amassing resources for major development programs.<sup>22</sup> A large group may form a limited partnership to accomplish designated drilling programs. Often these are organized on an annual basis. One group might form the 1965 drilling program, another group the 1966 drilling program, and so on. Such annual drilling programs may be further divided by particular areas or by drilling blocks.

Section 704 provides for a built-in carried interest in which a different allocation of expense and income takes place during the payout period. Moreover, the sharing of expenses during payout need not necessarily be in the same ratio as the sharing of income.<sup>23</sup> Another advantage is that partners may shift percentages at various points. For accounting purposes, care must be taken to clearly identify and define the points at which sharing percentages change. Limited and general partnerships are well recognized entities for tax purposes. Consequently, there is greater predictability of treatment when these forms are used than when use is made of the specially tailored, nonpartnership sharing arrangements. The following points should be considered in drafting a limited partnership agreement:

- (a) the prepayment and post-payout percentages should be clearly stated;
- (b) during the prepayment period, the general partners probably should have some share of profits and losses (If only limited partners receive income and share expenses during the payout period, in determining the status of the entity as an association taxable as a corporation, it is at least questionable that

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<sup>21</sup> *Palmer v. Bender*, 287 U.S. 551 (1933); G.C.M. 22730, 1941-1 Cum. Bull. 214.

<sup>22</sup> Collie & Driscoll, "Partnership Oil and Gas Operations Under Provisions of Internal Revenue Code of 1954," 33 Texas L. Rev. 792 (1955); Fillman, "Effect on the Investor's Group of New Subchapter K, 'Partners and Partnerships,' and the New Texas Limited Partnership Act," Southwestern Legal Foundation, Seventh Annual Inst. on Oil and Gas Law and Taxation 721 (1956).

<sup>23</sup> Treas. Reg. § 1.704-1 (1956). The reallocation of income and expenses must have "substantial economic effect." S. Rep. No. 1622, 83d Cong., 2d Sess. 379 (1954).

limited liability exists. This may actually pose no problem, however, for there is always a general partner who has a partnership interest—even though this might not presently be a paying interest. Under local law this fact results in his being liable for the entity's contracts and torts. Because of this, if the general partner is financially responsible, the arrangement should not be challenged as being other than a genuine limited partnership.)<sup>24</sup>

- (c) the payout period should be carefully defined;
- (d) during the exploratory and drilling program, it may be desirable to provide that a limited partner cannot dispose of his interest without first offering his interest to other limited partners or the general partner (This way the stability of organization may be preserved during its initial period.);
- (e) in case a limited partner is unable to fulfill his commitment to pay his share, provision must be made either for
  - (1) the forfeiture of his contribution;
  - (2) the purchase of his interest at an agreed, negotiated, or arbitrary price; or
  - (3) carrying the interest on some agreed basis.

Following the completion of the exploratory and drilling program, the general partner may bind the partnership by executing an operating agreement with an operating company. Even before the termination of the prepayment period, the partnership may be liquidated. The limited partners then become nonoperating co-owners under the usual operating agreement. When the payout period terminates, then the interests of those who were limited partners are then based on the post-payout percentages.

We now turn to those arrangements which are usually described as carried interests under the more restrictive definition, *i.e.*, non-partnership arrangements which have as their primary purpose the pooling of capital. Presented below are various examples of carried interest arrangements and an historical legal analysis of the cases dealing with such arrangements. In considering the examples and the fact patterns of the cases, one should keep in mind that the right to the depletion deduction is dependent upon the existence of an economic interest (a concept which has evolved in the tax cases).<sup>25</sup> Entitlement to the intangible drilling and development cost deduction is dependent upon the ownership or acquisition of the operating or working interest (a local law concept). To insure the availability of both deductions, the adroit draftsman will cause the full interest to vest outright in that party who is to report income and all expense attributable to such interest.

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<sup>24</sup> Treas. Reg. §§ 301-7701-2, 301-7701-3 (1960).

<sup>25</sup> See Sneed, "Another Look at the Economic Interest Concept," *Southwestern Legal Foundation Tenth Annual Inst. on Oil and Gas Law and Taxation* 353 (1959).

Example 1: The *Manahan* Type.<sup>26</sup>

The carried party (hereinafter termed "Carried") assigns his entire working interest in a lease to a carrying party (hereinafter termed "Carrier"). The instrument of conveyance contains covenants which require Carrier to drill and develop the property. When Carrier has recovered his cost and expenses, then either a 25 per cent interest in the working interest reverts to Carried, Carried has an option to purchase the 25 per cent interest, or Carrier is subject to a covenant to convey a 25 per cent interest to Carried. Carrier must look solely to the production from the property to recover his costs and expenses. Carried has no personal liability and has no ownership interest in the property during the payout period.

After the payout period, Carried and Carrier operate the properties as co-owners under an operating agreement in which the respective shares of income, cost, and expenses are allocated to each of the participating parties in the ratio of 25 per cent to Carried and 75 per cent to Carrier. Carrier will be entitled to all the income and deductions during the payout period. If Carried is entitled to a 25 per cent interest in equipment after payout, he will assign whatever basis he had in the original interest to depletable and depreciable assets in accordance with their respective values. Carrier will assign his basis in the transferred equipment to depletable property.

Example 2: The *Herndon* Type.<sup>27</sup>

Carried assigns a 75 per cent interest in the working interest to Carrier. In addition, Carried assigns to Carrier a production payment payable out of the 25 per cent working interest retained by Carried. The production payment is an amount equal to the expenditures to be made by Carrier in drilling and developing the property plus a profit factor. Carrier then develops the lease, 75 per cent for its own benefit and 25 per cent as consideration for the assigned production payment.

The receipt of the production payment from the retained 25 per cent interest will not result in income to Carrier since the interest is exchanged for development. Carrier will be entitled to all income during the payout period. Such income will be attributable to two separate property interests: the 75 per cent of the working interest assigned to Carrier and the production payment payable out of Carried's 25 per cent of the working interest. Carrier will deduct 75 per cent of intangible drilling and development costs and other expenses. He will capitalize as a cost of the production

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<sup>26</sup> *Manahan Oil Co.*, 8 T.C. 1159 (1947).

<sup>27</sup> *Herndon Drilling Co.*, 6 T.C. 628 (1946), *acq. in part*, 1946-2 Cum. Bull. 6.

payment acquired from Carried the remaining 25 per cent of such items as well as 25 per cent of the cost of intangible equipment.

Example 3: The *Abercrombie* Type.<sup>28</sup>

Carried assigns 75 per cent of the working interest to Carrier. Carried and Carrier then enter into a contractual arrangement by the terms of which Carrier is to *advance* the funds to develop Carried's 25 per cent interest. Although Carried will have no personal liability for the repayment of these funds, he acquires a present interest in the production and improvements, subject to the lien held by Carrier on both the production and the equipment attributable to Carried's 25 per cent interest as security for the payment of the funds advanced by Carrier. During the payout period, Carrier will receive the entire income and pay cost and expenses. Carried, however, will account for and be taxable on 25 per cent of the income less 25 per cent of costs and expenses attributable to his interest. Carrier treats the advance as an account receivable which, if not repaid from production or by foreclosure of the lien on equipment, would constitute a bad debt.

Example 4: The *Burton-Sutton*<sup>29</sup> or *Southwest Exploration*<sup>30</sup> Type.

Carried assigns his entire working interest in the lease to Carrier and reserves a 25 per cent net profit interest. The net profit interest is an overriding royalty property interest measured by 25 per cent of the net profit as defined in the instruments. Carrier, as the owner of the operating interest, will deduct all intangible drilling and development costs and expenses for the life of the property. Carried will begin to receive income attributable to his net profit overriding royalty when the properties reflect a net profit. Should the properties subsequently operate at a deficit, the net profit payments previously paid to Carried are not recoverable.

Carried will calculate percentage depletion on the net proceeds received which are attributable to the net profit interest; Carrier will calculate his percentage depletion on his share of gross income from the lease, excluding therefrom the landowner's royalty, any other overriding royalties, and Carried's net profit interest.

Assume that after the payout period the gross production from the leasehold interest, without regard to the outstanding 25 per cent net profit interest, is 100,000 dollars and that operating costs are 25,000 dollars. Carried's and Carrier's respective gross incomes for percentage depletion purpose are as follows:

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<sup>28</sup> *Commissioner v. Abercrombie*, 162 F.2d 338 (5th Cir. 1947).

<sup>29</sup> *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946).

<sup>30</sup> *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956).

	Carrier	Carried
Gross production .....	\$100,000	
25% net profit overriding royalty paid to Carried [25% x (100,000-25,000)]	(18,750)	\$18,750
Carrier's gross income for depletion purposes .....	\$ 81,250	\$18,750
Less expenses .....	25,000	<u>—0—</u>
Carrier's taxable income from the property for purposes of the 50% limitation....	<u>\$ 56,250</u>	<u>\$18,750</u>

The foregoing example is to be contrasted with that of Example 1 in which, after the payout period, Carried and Carrier would share the gross proceeds on the basis of 25,000 dollars-75,000 dollars and the expenses on the basis of 6,250 dollars-18,750 dollars. Thus, in Example 1, Carried's gross income base for percentage depletion purposes would be 25,000 dollars and Carrier's base for percentage depletion purposes would be 75,000 dollars.<sup>31</sup>

The foregoing examples illustrate the general principles involved. With them in mind, let us examine in historical perspective, the fact patterns, and results in relevant cases to determine if they support the results predicted in the illustrative examples.

#### The *McMurray* (1932) and *Armstrong* (1934) Cases

In *Reynolds v. McMurray*<sup>32</sup> and *Helvering v. Armstrong*,<sup>33</sup> Armstrong and the Ohio Oil Company owned oil leases in the proportion of 40-60 per cent respectively. They agreed that Ohio Oil would manage, control, develop, and operate the leases and would immediately drill a well at the expense of Ohio Oil. The Oil Company agreed to pay all costs, market the products, and charge and credit Armstrong's interest with its allocable share of such costs and revenues. Armstrong assigned part of his carried interest to McMurray. The court held that income was taxable to the carried party during the payout.<sup>34</sup>

<sup>31</sup> It was this difference in depletion calculation that resulted in the litigation in *United States v. Thomas*, 329 F.2d 119 (9th Cir. 1964). See also *Grandview Mines v. Commissioner*, 282 F.2d 700 (9th Cir. 1960).

<sup>32</sup> 60 F.2d 843 (10th Cir.), *cert. denied*, 287 U.S. 664 (1932).

<sup>33</sup> 69 F.2d 370 (9th Cir. 1934).

<sup>34</sup> The court concluded that:

- (1) the transaction resulted in the formation of a joint venture;
  - (2) the capital improvements on the carried party's property were income;
  - (3) the carried parties were in constructive receipt of income which was anticipatorily assigned to the carrying party for the carried party's benefit;
- and

Note the similarity with Example 3. Armstrong did *not* assign his property interest to the Oil Company, and, indeed, the court specifically noted this fact. The agreements recited the expenditure of funds *for the benefit* of Armstrong's interest; and, in fact, the drilling of a valuable well and the installation of valuable equipment *did* benefit Armstrong's present vested property interest. Moreover, the question was open as to whether or not Armstrong had a personal liability for the advances. He could conceivably have had such personal liability, in which case the arrangement was a means of discharging his personal debt.<sup>35</sup>

#### The *Harris* Case (1940)

In *T. K. Harris Co. v. Commissioner*,<sup>36</sup> the carrying party contracted to drill and equip gas wells on the carried party's interest. On payout the carried party would own the wells and equipment, and would sell the gas to the carrying party. Income was taxable to the carried party during the payout.

Note the similarity with Example 3. Carried party *owned* the property during the payout period and *acquired* title to all the equipment and production as the interest paid out, subject only to the sales arrangement with the carrier.

#### The *Hodges* Case (1941)

In *Hugh Hodges Drilling Co.*,<sup>37</sup> the operator received from the carried party an assignment of the *full* leasehold interest subject to a covenant on the operator's part to reconvey a fractional interest of the working interest at the time when the carrying party-operator had recovered a certain sum. Income was taxable entirely to the carrying party-operator; the court rejected the contention that the carried portion of the working interest was equivalent to an oil payment.

Note the similarity to Example 1. The carried party divested himself of title to his interest. Under the arrangement, he might

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(4) the income was used to discharge a legal, albeit nonpersonal, liability allocable to the carried party's share. A concurring opinion pointed out that there was *no explicit* negation of personal liability so that there was at least a doubt as to whether or not Armstrong *had to respond personally* for the advances for the benefit of his interest.

Reynolds v. McMurray, *supra* note 32, at 844-45.

<sup>35</sup> See *Anderson v. Commissioner*, 107 F.2d 459, 462 (10th Cir. 1939) (citing *McMurray* to the effect that when oil proceeds discharge a personal debt of the taxpayer, the income is taxable to him).

<sup>36</sup> 112 F.2d 76 (6th Cir. 1940).

<sup>37</sup> 43 B.T.A. 1045 (1941).

never again have an interest in the property should the payout fail to occur. With respect to the contention that the carried portion was a separate property interest, *i.e.*, an oil payment, note that the entire working interest was assigned. There was no attempt to create by the instruments a separate production payment.

#### G.C.M. 22730 (1941)

In G.C.M. 22730,<sup>38</sup> the Service ruled that under facts like those in *McMurray*, that case would not be followed and the income should be accounted for by the carrying party. Although the General Counsel's Memorandum as it relates to various oil and gas transactions is still relied on, its application to carried interests must be read against the background of the cases litigated before and since its promulgation. Thus, the analysis in G.C.M. 22730 did not take account of the significance of the lack of transfer of title, the acquisition of valuable improvements, nor the possible factor of personal liability which had been discussed in the concurring opinion in *McMurray*.

#### The *Herndon* Case (1946)

The drilling contractor in *Herndon Drilling Co.*<sup>39</sup> entered into a contract for the drilling of two wells on two leases. Pursuant to the arrangement, the contractor was assigned one-half of the working interest. By a separate conveyance, Herndon received the other half. However, this latter conveyance was subject to an agreement that it was in the nature of a mortgage to secure the contractor for costs and expense "advanced by [him] . . . hereunder for the account of the owners." When the costs had been recouped by the contractor, the contract provided for reassignment to the assignors.

The court held that the income was taxable to the drilling contractor because during the payout period he held the property interests to which the income was attributable. However, the court also held that he acquired two depletable interests: one was a depletable working interest; the other was a production payment, which continued to enlarge as further expenditures were made.

The fact that the separate interest was specifically identified as *in the nature of* a mortgage may have been the best argument for treating this interest as a production payment. In this connection, however, the court did say that the reference to the conveyance as a mortgage was *not* controlling on the issue of whether or not the carried party was a debtor whose debt was discharged

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<sup>38</sup> 1941-1 Cum. Bull. 214.

<sup>39</sup> 6 T.C. 628 (1946).

by the payments attributable to the assigned interest. This is not to say, however, that the court disregarded the similarity to a mortgage in reaching the conclusion that the interest was an assigned production payment.

Note the similarity to Example 2. Here was a case of an identifiable sum treated as an advance secured only by an assigned property interest which was vested in the carrying party and to which such party had to look for recovery of his investment.

### The *Manahan* Case (1947)

In *Manahan Oil Co.*,<sup>40</sup> Oil Company owned a full  $\frac{7}{8}$  working interest in an oil and gas lease. Oil Company entered into an agreement in which it was described as vendor and Manahan as vendee. Oil Company then conveyed half of  $\frac{7}{8}$  working interest and Manahan agreed to drill a well and pay all costs therefor. Oil Company agreed to assign an additional  $\frac{1}{4}$  of  $\frac{7}{8}$  working interest until Manahan had recouped the costs of development of the property from the  $\frac{1}{2}$  plus the  $\frac{1}{4}$ . When the amount had been recouped, the  $\frac{1}{4}$  of  $\frac{7}{8}$  interest would terminate and would thereafter be owned by Oil Company. Thereafter, Oil Company and Manahan would jointly operate the property, each bearing half the costs and collecting half the revenues. Manahan was taxable on the income from both the  $\frac{1}{2}$  and  $\frac{1}{4}$  of  $\frac{7}{8}$  interest during the payout period.

Note the similarity to Example 1. Oil Company might never reacquire the  $\frac{1}{4}$  of  $\frac{7}{8}$  interest if the property failed to pay out. One may argue that the economics of the *Manahan* arrangement are the same as that of *McMurray* and *Armstrong*, and that the difference in documentation is merely formalistic. This is not the case at all. In *McMurray* and *Armstrong*, title remained in the carried party; in *Manahan*, title was assigned. This is not mere formalism. Rights of creditors, heirs, and devisees, and accessibility to local taxing authorities are quite different in the two lines of cases.

Although *Manahan* may be distinguished from *McMurray* and *Armstrong*, it is less easily distinguished from *Herndon*. Why is the separately assigned half interest in *Herndon* treated as an assigned production payment while the separately assigned  $\frac{1}{4}$  interest in *Manahan* is treated as an assignment of the working interest for a temporary period? The court in *Manahan* gives no answer. One distinction, albeit tenuous, is that in *Herndon* the parties did describe the interest as in the nature of a mortgage for a sum to be advanced. Thus, the carrying party who advanced the money acquired as a property security the equivalent of the sum

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<sup>40</sup> 8 T.C. 1159 (1947).



advanced. In *Manahan*, on the other hand, the  $\frac{1}{4}$  interest assigned was not "in the nature of a mortgage"; it was precisely like the half interest assigned, except that the  $\frac{1}{4}$  interest terminated upon the recoupment of costs by the carrying party. The parties stipulated no advance, and nothing in the nature of a mortgage.

### The *Abercrombie* Case (1947)

With the distinction established above between the *McMurray* and *Armstrong* cases on the one side and *Manahan* on the other, the decision in *Commissioner v. Abercrombie*<sup>41</sup> seems quite explicable.

The facts in brief are that assignor *A* assigned to Abercrombie and others *B*, oil and gas leases for a bonus of 600,000 dollars and reserved a production payment of 2,250,000 dollars payable out of  $\frac{1}{4}$  of production, and an additional  $\frac{1}{16}$  carried working interest, including  $\frac{1}{16}$  of any personal property placed on the leases. The court held that during the payout period *A* was accountable for the income and expenses attributable to the  $\frac{1}{16}$  interest.

Note the similarity to Example 3. Assignors retained title and they had the benefit of  $\frac{1}{16}$  of the personal property placed on the lease. The carried interest in *Abercrombie* was a perpetual one; accordingly, it may be argued that it is more nearly like Example 4 and should be treated as the equivalent of a net profit interest. However, the significant difference arises out of the acquisition by the carried party of an interest in equipment. A net profit overriding royalty interest is a nonrisk-bearing, nonexecuted type interest in minerals in place. Under local property law, it is an incorporeal interest to which equipment would not affix. In *Abercrombie*, the carried party acquired equipment as would be the case of a working interest owner.

### The *Rubin* Case (1958)

In *Dave Rubin*,<sup>42</sup> *H* and *S* advanced loans to Rubin to pay his creditors and took assignments of his claims. Rubin then owed these amounts to *H* and *S*. He transferred to *H* and *S* half the working interest and the personal property. *H* and *S* were entitled to receive all the proceeds until they had been reimbursed. Thus, Rubin pledged his interest to repay a loan. *H* and *S* could look to the production and to considerable equipment on the lease. The court held that the income was taxable to Rubin.

Note the similarity to Example 3. This was not a carried

<sup>41</sup> 162 F.2d 338 (5th Cir. 1947). *Foster v. United States*, 85 F. Supp. 447 (S.D. Tex. 1949); See John S. Carlson, 58-1 U.S. Tax Cas. ¶ 9139 (N.D. Okla. 1957).

<sup>42</sup> 1959 P-H Tax Ct. Mem. ¶ 59223.

interest in the usual pattern. Rubin made an arrangement to repay his preexisting debts, and the income and deductions attributable to the property interest which discharged those debts belonged to Rubin.

### The *Prater* Case (1959)

In *Prater v. Commissioner*,<sup>43</sup> taxpayer who owned a  $\frac{1}{4}$  interest in properties joined in mortgaging the properties for development loans but did *not* sign the notes and was not personally liable. He did not assign the interest to the parties who were personally liable and who were carrying him for development.

The Fifth Circuit Court of Appeals held that Prater could deduct the losses attributable to his interest. That court followed its own *Abercrombie* decision; for just as *Abercrombie* stands for the proposition that the carrying party did *not* have to account for the income from the property, *Prater* holds that the carried party can deduct the losses.

Note the similarity to Example 3. Prater retained title to his interest; he did join in mortgaging his interest but did not sign the notes; and the agreements indicated that he would acquire his proportionate part of the cost of equipment.

### The *Wood* Case (1960)

In *Wood v. Commissioner*,<sup>44</sup> Mr. and Mrs. Wood were divorced. They owned oil and gas leases and owed community debts, for which Mrs. Wood had no personal liability. The divorce decree awarded Mrs. Wood a half interest in the oil and gas leases "after the payment of community debts." Until the debts were paid, Mrs. Wood had nothing; she was, in effect, being carried by her husband who held the entire property interest to discharge *his* debts. The case is not illustrative of the usual carried interest, but the analogies are the same.

Note the similarity to Example 1. Mrs. Wood had no property interest and no personal liability; whatever interest she had would vest in the future; therefore, she had no income during the payout period.

### The *Weinert* Case<sup>45</sup> (1960)

Weinert arranged with Lehman to develop certain properties and to construct a processing plant. Weinert assigned an interest

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<sup>43</sup> 273 F.2d 124 (5th Cir. 1959).

<sup>44</sup> 274 F.2d 268 (5th Cir. 1960). See Byron H. Farwell, 35 T.C. 454 (1960), *acq.*, 1961-2 Cum. Bull. 4.

<sup>45</sup> *Weinert v. Commissioner*, 294 F.2d 750 (5th Cir. 1961).

in the properties to a trustee to pay the net profits to Lehman. When Lehman had recovered his costs, the trustee and Lehman were to reassign the interest to Weinert. The Fifth Circuit Court of Appeals held that Weinert was not taxable on the net profits of the assigned interest during the payout period. In an exhaustive opinion, the court rejected the contention that Weinert had participated in a loan transaction; it distinguished *Prater* and *Abercrombie* on the grounds that Weinert gave up his interest in the property and might never recover it unless Lehman recouped his expenditures. Accordingly, the court emphasized the placing of title as an important criterion in determining taxability.

Note the similarity to Example 1. Weinert conveyed his title to the trustee and might never recover it if there were no payout. Consequently, during the payout period, which could last indefinitely, Weinert had no interest in the property, no personal obligation, and no interest in equipment.

#### The Sowell Case (1962)

*Sowell v. Commissioner*,<sup>46</sup> like *Wood*, is not a carried interest case in the usual sense but the analogies are the same. Sowell placed legal title to properties in his nominee who used the property to obtain funds from the bank and then misappropriated the funds. As Sowell had authorized the transaction, he was bound by the action of his nominee. Accordingly, as the oil and gas runs paid off the debt, Sowell was accountable for the income, entitled to the depletion deduction, and also entitled to the deduction for the worthless debt from the defrauding nominee.

Note the similarity to Example 3. Sowell had title to the property, his property was liable for the debt, and the income from the property discharged that debt. The income, therefore, was attributable to Sowell.

#### The Thomas Case (1964)

*United States v. Thomas*<sup>47</sup> is the most recent in the series of carried interest cases. *A* and *B* owned undivided percentage interests in property in certain oil and gas subleases. The operating agreements between them provided that *A* would have no personal liability for costs and expenses, *B* would make expenditures for all costs in connection with the development of the property, *B* would have exclusive control of the property, *B* would own all improvements, and *B* would look solely to production for reimbursement of its expenditures. Thus, for the life of the property (an indeter-

<sup>46</sup> 302 F.2d 177 (5th Cir. 1962).

<sup>47</sup> 329 F.2d 119 (9th Cir. 1964).

minate, or unlimited, period), *A*'s sole share was a percentage of the net proceeds. The court held that *A*'s interest was the equivalent of a net profit interest rather than a carried working interest. The case approves the Service's position that an "unlimited carry" is the equivalent of a net profit interest.

Note the similarity to Example 4. For the life of the property *A*'s interest would not be greater than a percentage of the net proceeds; *A* would acquire no interest in personal property, and would have no personal liability. He bargained away all but the equivalent of an overriding royalty. Notwithstanding the similarity to the net profit interest it should be observed that *A* *did* have title to the working interest; he *did* have the possibility of reacquiring his full operating interest if the operating agreement were rescinded, modified, or terminated, and his account was charged with a nonpersonal liability for interest at 4 per cent on the deficit in the "joint account" as if *A* were being *advanced* the money for the development of *his* interest.

The documentation of the transaction was unfortunate in that it created a hybrid-type interest. It is regrettable that the case was not decided on the particular factors relevant to the holding without reference to other carried interest cases. The court describes a carried interest in note 3 of the opinion as an arrangement in which one co-owner of a lease advances "all or some part of the development costs on behalf of the others, and to recover such advances from future production, if any, accruing to the other owners' share of the working interest." The court cites *Weinert*,<sup>48</sup> yet in *Weinert* the title of the carried party was conveyed to a trustee, so that the carrying party did not make *advances* on behalf of the others, rather he expended for his own benefit. The trustee held the title and was not to assign it to the carried party until the carrying party was repaid for his expenses; the trustee held the title for the benefit of the carrying party who reported the income and deductions for the entire interest.

It is also regrettable that the court overruled *Helvering v. Armstrong*,<sup>49</sup> for, as was pointed out previously, in *Armstrong* the carried party retained title to the operating interest, acquired valuable improvements, and perhaps could even have been held personally liable for the advances. *Thomas* and *Armstrong* are quite different. *Thomas* could have been reconciled to precedent without disrupting the decisional developments supporting the kinds of arrangements described in Examples 1 and 2.

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<sup>48</sup> *Weinert v. Commissioner*, *supra* note 45.

<sup>49</sup> *Supra* note 33.

## Guidelines for the Draftsman

The following should be observed in drafting documents for financing arrangements patterned after those adjudicated in the foregoing cases. If the parties desire a *Manahan* type arrangement:

(a) The carried party should assign his entire interest in the property, or such part of the interest with respect to which he intends to be carried, to the carrying party for the payout period.

(b) The carried party will then be given an option or right of reentry by the carrying party to reacquire some interest in the property after the payout period.

(c) Development loans or other arrangements for financing development should be negotiated by the carrying party *after* the interests are assigned to him.

(d) The carried party should have no present rights in the carried interest, nor improvements thereon, nor should he have any obligations in respect thereto during the payout period.

There is no partnership nor is there an association during the payout period since the carried party has no interest in the property.<sup>50</sup>

If the parties desire a *Herndon* type arrangement:

(a) The carried party should carve out a production payment, described carefully in the documents, and assign the same to the carrying party.

(b) The carved-out production payment in the hands of the carrying party may be mortgaged by him but the carried party should not execute any notes or security instruments with respect to his retained working interest from which the production payment is carved.

(c) The production payment carved out of the carried party's interest should be payable out of less than 100 per cent of the production. A small fraction of the runs will cover minor or incidental expenses which may burden the carried party's interest during the payout period. Without such income the Service may contend that the carried party would have to capitalize expenses to the extent they exceed income.

If the parties desire an *Abercrombie* or *Prater* type arrangement:

(a) The carried party should retain title to the interest being carried.

(b) The carried party and the carrying party should execute a contractual arrangement calling for advances from the carrying

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<sup>50</sup> Comment, "Associations: Stierwalt, I.T. 3930 and Regulations," 10 Oil & Gas Tax Q. 177 (1961).

party to the carried party for the benefit of the carried party's interest.

(c) The carried party should acquire an interest in improvements attributable to his share.

(d) The carried party may execute such documents as will evidence his continuing interest in the property and improvements, his nonpersonal liability and the acknowledgment of advances made for his benefit.

(e) The carried party and the carrier should file a partnership information return electing out of any subchapter K application. It may be advisable to consider the reservation of the right to take production in kind and other restrictions which will take the arrangement out of the association category.<sup>51</sup>

If the parties desire a *Burton-Sutton* or *Southwest Exploration* type arrangement:

(a) The entire interest in the working, or operating interest, should be assigned subject to the reservation and exception of a net profit interest.

(b) The net profit reservation should be described as an overriding royalty measured by net profits, and the net profit accounting should be carefully defined.

Throughout the discussion of the various forms of carried interests, we have assumed that the preliminary negotiations were voluntary. In states having compulsory pooling and unitization laws, a regulatory agency may require that non-consenting mineral owners accept a bonus and convey a lease to the unit or contribute their interests in some form of carried interest. Enabling provisions in relevant statutes permit the necessary vesting of interests in order to achieve the purposes of a pooling or unit plan.<sup>52</sup> Thus, an order of a regulatory commission could effect the same consequences as any one of the voluntary arrangements described above.

C. *Contributor has no interest in the property to be developed but enters into an arrangement pursuant to which he is carried for an interest in exchange for services, supplies, or equipment.*

#### Example 5

A geologist performs services in connection with the development of the property for which he receives a percentage interest in property, or a contract, or letter agreement, acknowledging the obligation of the developer to carry the geologist for a percentage

<sup>51</sup> Comment, "Is the Carried Interest a Partnership?" 13 Oil & Gas Tax Q. 51, 65 (1964).

<sup>52</sup> See, e.g., Okla. Stat. Ann. tit. 52, § 287.9 (Supp. 1965); Mich. Stat. Ann. § 13.139(118) (Supp. 1963).

interest and after payout to deliver on demand an assignment of such interest.

The contribution of services in connection with development for an interest in the property does not cause income to be attributable to the service contributor. Although G.C.M. 22730<sup>53</sup> does not describe particularly an instance of services exchanged for an interest, private rulings have been issued approving the nonrecognition of income in such transactions. A transaction involving supplies and equipment for an interest is, of course, described in the ruling as one in which income is not attributable to either party. The service contributor's basis in the property acquired will be equal to any expenditures incident to the services performed. This might include traveling, costs of records, and other expenses attributable to the engagement.

In *Donald P. Oak*,<sup>54</sup> the taxpayer received a 10 per cent carried interest in consideration for services in connection with the acquisition of such properties. The court said the lack of formal conveyance to the taxpayer evidenced the parties' intentions that Oak had no present economic interest in the properties, but only a future right. He, therefore, had no income or deductions attributable to the interest.

The case is distinguishable from Example 5; in *Oak* there was not a present legal interest in property nor was there a percentage equitable interest which could be made into a legal interest by specific enforcement of a conveyance of such an interest.

In *Weiner v. Campbell*,<sup>55</sup> the taxpayer group agreed to provide services to certain investors in acquiring oil properties, for which services the taxpayers would be entitled to 25 per cent of the properties. The court held that a joint venture had been formed and taxpayers had contributed services for a share in the venture. The receipt of the 25 per cent interest was not income.

Two recent cases,<sup>56</sup> have caused concern about the validity of the proposition that an exchange of services for an interest is a nontaxable transaction. In *James A. Lewis Engineering, Inc. v. Commissioner*,<sup>57</sup> taxpayer's services related to a water flood program for which taxpayer was to receive an interest in the property. Under the arrangement taxpayer first informed and notified the parties

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<sup>53</sup> 1941-1 Cum. Bull. 214. See also I.T. 4003, 1950-1 Cum. Bull. 10.

<sup>54</sup> 46 B.T.A. 265 (1942); see also *Commissioner v. Happold*, 141 F.2d 199 (5th Cir. 1944).

<sup>55</sup> 54-1 U.S. Tax Cas. ¶ 9133 (N.D. Tex. 1953).

<sup>56</sup> *James A. Lewis Engineering, Inc. v. Commissioner*, 339 F.2d 706 (5th Cir. 1964); *United States v. Frazell*, *supra* note 4.

<sup>57</sup> *Supra* note 56.

concerning the desirability of undertaking a water flood program in 1953. In 1956, the program began and was installed in 1957, when taxpayer received his interest. The court held that the nature of the particular project had to do with operations rather than development. Citing the Tax Court, the Fifth Circuit Court of Appeals noted that "the purpose of the pilot water flood operation was to determine whether or not the introduction of water would result in an increased oil recovery from producing wells. . . . Water flooding is . . . a method for the recovery of oil in place from the present producing horizon!"<sup>58</sup> Therefore, G.C.M. 22730 was inapplicable; and the exchange of services for an operating, rather than a development, function became a taxable event.

Still to be determined was to which period the income was attributable. The contingencies set out in a 1953 letter agreement between taxpayer and the owners led the court to hold that taxpayer was not in receipt of income in 1953, nor in 1956, but that he was in 1957 when, *according to the agreement*, taxpayer first had a right to the interest.

It is not the purpose here to debate the development-operations dichotomy which was an issue in the case. The disturbing aspect of the decision is a gratuitous remark in the opinion which casts doubt on the viability of G.C.M. 22730:

Unless a careful analysis of the reasons underlying the issuing of G.C.M. 22730 compelled it, the court would have great difficulty accepting a construction of the Code that would fly in the face of the general provisions of the tax laws to the effect that compensation for services must be returned as a part of gross income.<sup>59</sup>

This comment together with the decision in *Frazell* places in jeopardy the usual property-for-services arrangement.

In *Frazell* the facts in brief were that in 1951 the taxpayer geologist entered into an arrangement with Wheless and Woolf which agreement was *in part* compensatory for services for a regular periodic cash amount and *in part* an exchange of services for a carried interest. If Wheless and Woolf purchased mineral properties on Frazell's recommendations, then Frazell was to be carried for an interest which would be assigned to him after the payout. The venture was incorporated in 1955. The court held that the corporate stock was income to Frazell under either one of two views: (1) that the stock representing Frazell's interest in the venture was

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<sup>58</sup> *Id.* at 710.

<sup>59</sup> *Id.* at 709.



transferred to him in 1955 as compensation for services and was income to him under Treas. Reg. 1.721-1(b)(1), or (2) that so much of the value of the stock of the corporation which Frazell received for his services was income to him under section 351(a) of the Internal Revenue Code. Frazell did transfer some maps to the corporation; therefore, the court remanded the case to the district court to determine the portion of the value of the stock which Frazell received for the maps, as this amount would be covered by the nonrecognition provisions of section 351.

There are several aspects of *Frazell* that make difficult any analysis of its impact on later cases. It is regrettable that the documentation of the transaction did not clearly separate the compensation feature from the carried interest feature. Disregarding for the moment the partnership question, one may contend that, had Frazell's compensation been distinctly separate, and had he been entitled to an interest for his services, and had such interest been simultaneously assigned to the others for a carried period, then the arrangement would have been within the purview of G.C.M. 22730 and private rulings issued thereunder.

#### Guidelines for the Draftsman

In drafting a carried interest arrangement which is designed to accommodate a fact pattern similar to that in *Frazell* it should be observed that: (1) the compensation feature of the contract should be distinctly separated from the carried interest feature; (2) the carried interest should be described as an interest *in praesenti* to which the geologist is presently entitled for services but which interest he assigns to the developers to carry him for the payout period; (3) lest the arrangement be considered a partnership, the parties may wish to "elect out" under section 761. The parties thereby envisage a sharing of resources for the acquisition of co-ownership interests for their respective benefits; but association for joint profit should be negated.

The foregoing discussion assumes a nonpartnership sharing arrangement. On the other hand, a limited partnership may provide the best accommodation for such transactions. Geologists, accountants, lawyers, or others may acquire interests in a partnership for services; and in accordance with the partnership agreement, they may be carried for a period. The formation of the partnership does not result in recognition of income to the partners contributing services or capital for an interest. However, if a service contributor receives a transfer of capital from the other partners as compensation, then he will realize income to the extent of the value of the

interest received. In this connection, if the interest is subject, say, to various restrictions on its transfer, then its value at time of receipt may be negligible.

If a service contributor receives for his services an interest in the partnership which is not the result of a transfer of capital from the other partners, then section 721 and the regulations thereunder<sup>60</sup> indicate that the nonrecognition rule of section 721 will not apply. Income is recognized to "the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation . . . ." <sup>61</sup> The documents should make clear that an individual partner being carried for a period does not acquire an interest in equipment, except insofar as such interest is paid for by him from his share of income.

The opinion in *Frazell* beclouds the interpretation of these section 721 transactions as they may be affected by section 704; for in that case, Wheless and Woolf were entitled outright to their interest. Therefore, there was no transfer of capital, as that is described in the regulations, to create an exception to the nonrecognition provisions of section 721. Nevertheless, the court held that there was such a transfer of capital and it used that transfer as a basis for its decision that Frazell had been compensated to the extent of the value of the stock which he received.

The Regulations under section 704<sup>62</sup> relate to the carrying of a service contributor. In this connection, however, T.D. 6771<sup>63</sup> recently modified the regulations in a curious way. Example 5 of section 1.704-1(b)(2) is set out below with the new matter in italics and eliminated words in brackets.

G and H, *each of whom is engaged as a sole proprietor in the business of developing and marketing electronic devices*, enter into a partnership agreement to develop and market [an] electronic devices. H [an electronics engineer] contributes \$2,500 cash and agrees to devote his full-time services to the partnership. G contributes \$100,000 cash and agrees to obtain a loan for the partnership of any additional capital needed. The partnership agreement provides that the full amount of any research and experimental expenditures and any interest on partnership loans are to be charged to G. It also provides that G's distributive share is to be 90 percent of partnership income or loss computed without re-

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<sup>60</sup> Treas. Reg. § 1.721-1(a) & (b) (1956); Rev. Rul. 54-84, 1954-1 Cum. Bull. 284.

<sup>61</sup> Treas. Reg. § 1.721-1(b)(1) (1956).

<sup>62</sup> Treas. Reg. § 1.704-1(b)(2) example 5 (1956), as amended, T.D. 677; 1964-2 Cum. Bull. 177.

<sup>63</sup> 1964-2 Cum. Bull. 177, amending Treas. Reg. § 1.704-1(b)(2) (1964).

duction by such research and experimental expenditures and such interest, until all loans have been repaid and G has received through his 90 percent share of income an amount equal to the full amount of such research and experimental expenditures, of such interest, and his share of any partnership operating losses. During this time H's distributive share will be 10 percent. Thereafter, G and H will share profits and losses equally. Since all of the research and experimental expenditures and interest specially allocated to G are in fact borne by G, the allocation will be recognized in the absence of other circumstances showing that its principal purpose was tax avoidance or evasion.

This example as originally promulgated has always been considered applicable to the capital and service contributors in an oil and gas sharing arrangement. The changes were described as clarifying only, but in the wake of *Frazell*, it is odd that a change which strikes out the description of H as being an engineer (characteristically a service contributor) and now describes him as being in the electronics *business* (characteristically a capital contributor) would be clarifying only. In any event draftsmen or partnership agreements probably should proceed as if *Frazell* is to be confined to its own peculiar facts. Certainly in light of sections 721, 731, and 704, the agreement could be drafted to take in the service contributor and carry him for his interest without adverse consequences.

#### CONCLUSION

The concept of sharing arrangements in light of the recent cases of *Frazell*, *Lewis*, and *Thomas* is still unclear. The important lesson of the cases, however, is careful drafting. Clean, simply stated rights, duties, and obligations between people and property can go a long way in settling the dust.